

Pusan Bank

2Q07 results review: Steaming ahead on the right course

- **Another strong quarter:** PSB released its 2Q07 results on July 18 with NP coming in at W79B, higher than our estimate of W63B. The main reasons behind the solid 2Q07 earnings were: (1) higher-than-expected NII from NIM recovery and strong loan growth (8% Q/Q growth); (2) boost in non-interest income, mainly due to PF-related fees; and (3) lower-than-expected SG&A costs. We raise our NP estimate for FY07 from W254B to W271B based on the strong 2Q07 results.
- **Still positive on PSB:** We remain positive PSB. The key drivers for stock, in our view, are: (1) management seems well committed to profitability; (2) robust industrial activity in Pusan area advantageous both on the asset and liabilities side (e.g. favorable for corporate deposit-taking); and (3) benign credit cycle in the Pusan/Kyongnam area leading to lower credit costs.
- **Catching up to its peers:** PSB has been one of the top performers in 2007 (YTD: 41% ↑) but we believe there is still more upside. PSB (1.4x FY08E P/B) has been trading at a relative discount to its peers, but we believe the valuation gap with its peers should narrow as PSB gains ground in profitability.
- **We raise our PT to W20,000:** We are raising our PT to W20,000 (June '08) from our previous W17,000 (Dec. '07) reflecting our increased confidence on earnings. Our PT is based on our DDM analysis implies 1.7x FY08E BVPS and 9.8x FY08E EPS. Key risk is an overall downturn of the local economy.

Reuters: 005280.KS, Bloomberg: 005280 KS
Won in billions, year-end December

	FY05	FY06	FY07E	FY08E			ADR	
Net profit	179	184	271	298	52-week range	W15,900-10,900	Reuters	n.a.
Basic EPS (rep'd) (Won)	1,220	1,253	1,849	2,032	Market cap	W2,296B	Bloomberg	n.a.
Cash adj. EPS (Won)	1,142	1,159	1,848	2,032	Market cap	US\$2,506MM	52-wk range	n.a.
Cash DPS (Won)	405	425	575	650	Shares outstanding	147MM	Ratio	n.a.
Basic EPS growth (%)	34.8	2.7	47.5	9.9	Free float	85.9%	Avg daily volume	n.a.
Cash adj. EPS growth (%)	49.2	1.5	59.5	9.9	Avg daily value	W13.3B	Current prem (%)	n.a.
ROE (%)	16.5	15.2	19.6	18.6	Avg daily value	US\$14.5MM	13-wk avg disc (%)	n.a.
Cash Adj. ROE (%)	15.4	14.0	19.6	18.6	Avg daily volume	0.9 MM shares	52-wk avg disc (%)	n.a.
P/E (basic) (x)	12.8	12.5	8.5	7.7	KOSPI	1,930.70		
P/E (cash adj.) (x)	13.7	13.5	8.5	7.7	Exchange rate	W 916/US\$1		
BVPS (Won)	7,816	8,718	10,163	11,647				
Tangible NAV (Won)	7,816	8,718	10,163	11,647	Performance	1 mth	3 mths	12 mths
P/BV (x)	2.0	1.8	1.5	1.3	Absolute (%)	15.5	11.4	41.0
Div. Yield (%)	2.6	2.7	3.7	4.2	Relative (%)	8.1	-11.5	-9.9

Source: Company reports, Bloomberg, and JPMorgan estimates.

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Overweight

W15,650

18 July 2007
Price Target: W20,000

South Korea
Banks

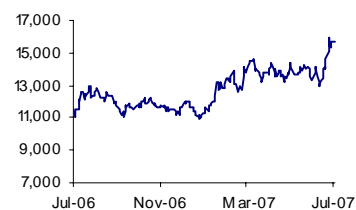
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Absolute performance

July 17, 2006 = 100



Source: Datastream

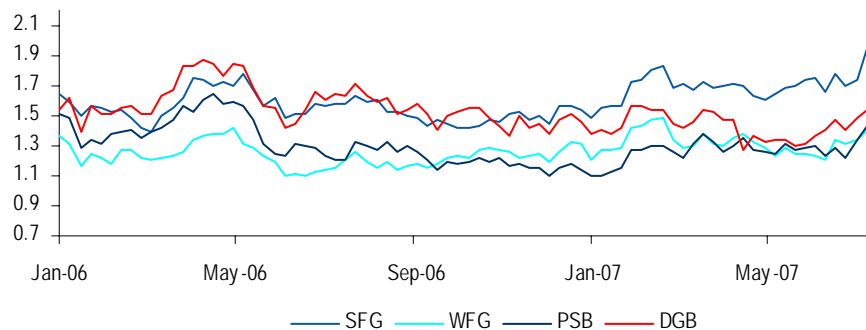
We remain positive on PSB

Since the beginning of the month, the share price has moved up W2,300 to W15,650. Despite the sharp rise, we believe there is more upside based on our new PT of W20,000 (June 2008). PSB showed another round of strong results in 2Q07 and we expect this trend to be sustained. We believe PSB should be able to surpass its original NP target of W237 billion easily and to also possibly reach W300 billion in FY08.

In terms of valuation, PSB is currently trading at a discount to its peers, namely Daegu Bank (DGB). We believe that the valuation gap between PSB and DGB should narrow as PSB gains ground in profitability. PSB is one of our top picks in the banking universe at this time.

Figure 1: Korean banks-12-month forward P/B trend

X



Source: Company reports and JPMorgan estimates.

Key reasons behind our positive view

Greater confidence on PSB's management

Based on our recent discussions with the CEO and CFO, we believe PSB is keeping to its management objectives that are geared towards profitability, especially on keeping NIM stable and asset quality in check.

Robust industrial activity in area to continue

For the near term, we expect the robust shipbuilding sector to drive growth in the region and this should benefit PSB both on the asset and liabilities side. In the mid/long-term, we believe Pusan being the second largest city in Korea with the nation's main port and also a vibrant cultural sector, should show continued growth.

Lower risk profile should keep credit costs down

We expect credit costs to remain low as PSB seems to be less exposed to possible risk areas such as real estate related loans and SoHos. We have confidence that PSB's credit cost should remain low as PSB has the ability to effectively manage credit risk and also has a high NPL coverage ratio (180% as of 2Q07).

More favorable competitive dynamics

Kyongnam Bank seems to be finally calming down as loan growth has taken an about turn recently. A less aggressive Kyongnam Bank should benefit PSB both on the asset and liabilities side.

2Q07 results review

Key takeaways of 2Q07 results

Pusan Bank (PSB) released its 2Q07 results during an analyst meeting on July 18, 2007 with 2Q07 NP coming in at W79 billion, which is higher than our estimate of W63 billion and consensus (W63 billion). The main reason behind the higher-than-expected earnings were (1) higher net interest income realized as NIM showed recovery in 2Q07 and strong loan growth was achieved, (2) boost in non-interest income mainly due to project financing related fees, and (3) lower-than-expected SG&A costs.

Key tidbits on 2Q07 results

- Loan growth of 8% Q/Q achieved in 2Q07 with SME segment being the main area of growth.
- Quarterly NIM shows increase of 2bp to 3.06% in 2Q07 from the previous quarter leading to a rise of aggregate NIM to 3.05%.
- Contributions to the Pusan government reflected in 2Q07 numbers (around W3 billion) contrary to previous years when they were book in 3Q07.

Table 1: PSB—2Q07 results review

Won in billions, year-end December

	2Q05	2Q06	1Q07	2Q07	Y/Y(%)	Q/Q(%)
Income statement						
Net interest income	147	150	164	173	15.1	5.6
Non-interest income (net)	11	16	26	26	64.5	0.0
Total operating revenue	158	166	189	199	19.8	5.4
Operating expenses	75	82	78	80	-2.8	2.2
Pre-provision operating profit	83	84	111	119	41.9	7.6
Loan loss provisions	13	10	5	7	-29.7	40.6
Post-provision operating profit	70	74	106	112	51.6	6.0
Other (non-op) income	6	12	-1	-3	NA	NA
Profit before taxes	76	86	106	109	27.0	3.0
Income tax	21	24	29	30	26.4	4.6
Net profits	54	62	76	79	27.5	3.6
Balance sheet						
Assets	18,404	20,562	22,150	24,434	18.8	10.3
Loans	11,773	13,453	15,528	16,961	26.1	9.2
Deposits	13,220	13,777	14,116	14,989	8.8	6.2
Equity	1,081	1,197	1,294	1,370	14.4	5.8
Book value (Won)	7,371	8,164	8,823	9,338	14.4	5.8
Ratios (%)						
ROA	1.2	1.3	1.4	1	8.4	-3.7
ROE	20.7	21.3	24.0	24	11.6	-1.2
Loans/deposits	89.1	97.6	110.0	113	15.9	2.9
NPLs/loans	1.1	0.9	0.8	1	-24.1	-11.8
Tier 1 ratio	9.5	9.2	8.4	8	-7.4	1.4
Total CAR	12.5	11.6	11.9	11	-5.6	-8.2

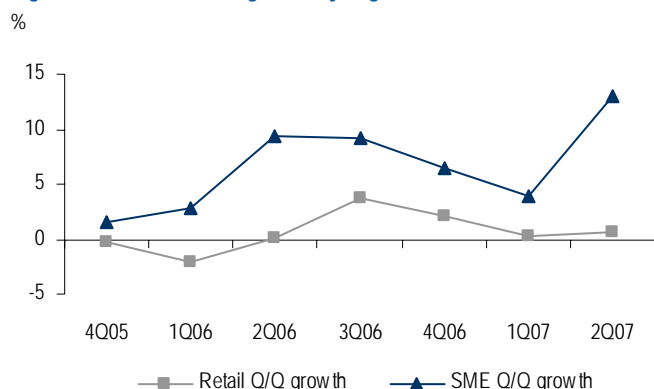
Source: Company reports.

Copious demand but controlled loan growth

PSB realized 8.1% Q/Q loan growth in 2Q07, outstripping the 1Q07 level of 2.5% by a mile. PSB has already achieved over 10% loan growth and hence should easily meet its loan growth target of 12% for FY07. The level of growth seems somewhat worrisome but considering the loan growth was achieved without sacrificing NIM, this is positive for the bank. Basically, due to the abundant loan demand in the area and also cooling down of growth by Kyongnam Bank (Woori Financial Group's subsidiary), high level of growth was possible.

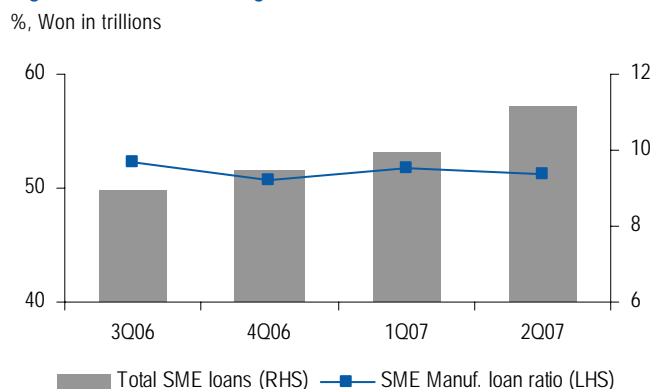
Owing to the strong performance by the shipbuilding industry, which is concentrated in the Kyongnam region, the local economy is being propped up. For the near term, we expect the shipbuilding sector to drive growth in the region. In the mid/long-term, we believe Pusan being the second largest city in Korea with the nation's main port and also a vibrant cultural sector, should show continued growth.

Figure 2: PSB—Q/Q loan growth by segment



Source: Company reports.

Figure 3: PSB—SME loan growth related statistics



Source: Company reports.

Key points regarding loan origination

- SME segment was again the main driver of loan growth with the balance increasing by W1.2 trillion in 2Q07 from the previous quarter (13% Q/Q growth). Of the total SME loan growth, around W281 billion was for facilities investment as shipbuilding/machinery related companies continue to expand operations. For the near term, this trend is expected to continue.
- Project financing (PF) remains another area of growth with PF loans increasing by W250 billion in 2Q07 to W840 billion. As PF loans are higher-yielding than other loans (around 7.5-8% average yield), PSB is expected to maintain growth in this area but keeping to loans of relatively high quality.
- Retail loan growth again languished growing by only 0.6% Q/Q in 2Q07 but disparate to 1Q07, there was meaningful growth in the mortgage loan segment (Q/Q growth of 7% in 2Q07). On the other hand, unsecured retail loans showed a decline of 3.8% Q/Q in 2Q07 as student loan balance shrank by W45 billion. Whether the mortgage loan trend can be maintained is uncertain but it seems there may be more positive signs going forth.

NIM shows another quarter of recovery

For the third quarter in a row, PSB has shown an improvement in quarterly NIM rising by 2bp in 2Q07 to 3.06% from 1Q07 (4Q06: rose 6bp Q/Q to 2.97%) owing to PSB's painstaking efforts to control NIM on both the asset and liabilities side. It seems that PSB is enjoying the positive effects created by the robust shipbuilding sector in the region.

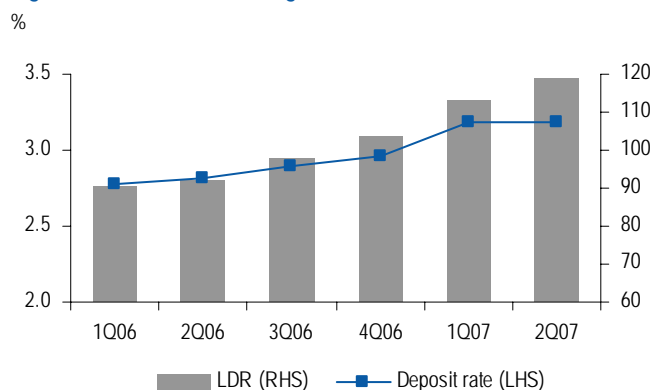
We believe PSB's management should maintain a level of loan growth that would not harm margins going forth as was the case in the past couple of quarters. Asset yields may be less pressured as loan demand should be abundant in the near term and also Kyongnam Bank may be less aggressive in 2H07. Even assuming moderate loan growth, with loan-to-deposit ratio at 118% as of 2Q07, the bank needs to continue efforts to retain customer deposits and attract more corporate/public sector funds.

Figure 4: PSB—Monthly NIM trend



Source: Company reports.

Figure 5: PSB—LDR & funding cost trend



Source: Company reports.

Key points regarding NIM

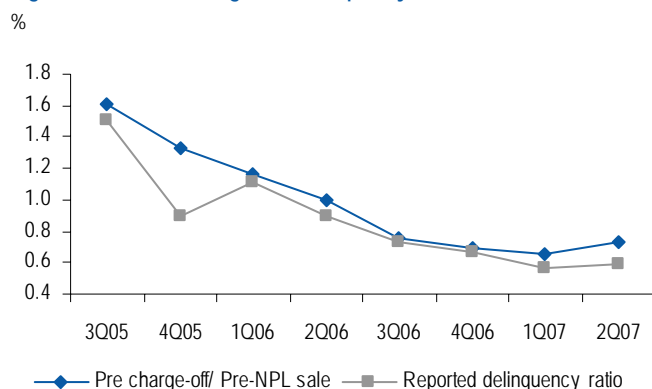
- Loan yields rise by 3bp to 7.12% owing to abundant loan demand in the region from the robust shipbuilding sector, which enables PSB to be more selective in its loan origination. PSB seems to be sustaining its de-marketing of legacy low-priced loans. To add, strong relationships with the local companies is also helping in PSB having advantage over competing banks.
- Tight control is being maintained on pricing with the branch managers basically having almost no flexibility in pricing loans and deposits. In the case of lending rates, if the branch wants to lower the pricing approval is needed from the head office.
- Slight decrease in low cost funding but decrease of its retail demand deposits was made up by strong inflow of money into corporate liberal deposits (net increase of W48 billion in 2Q07 from 1Q07). Compared to demand deposits (yield of 0.33% as of 2Q07), yields for corporate liberal deposits are higher (2.76% as of 2Q07) but it is still lower than time deposits or debentures.
- Pro-active push into project financing segment, which have yields at the 8% level, has enabled a climb in yields and with PSB continuing to focus in this segment to boost profitability.
- Loan growth slowdown expected at Kyongnam should lessen competitive pressure leading to less pressure on pricing.

Credit cycle still benign

PSB continues to maintain healthy asset quality with NPL ratio falling to 0.68% in 2Q07 from 0.79% in the previous quarter with precautionary & below loan ratio also improving to 1.8% as of 2Q07. Credit cost (provisions-to-total credit) in 2Q07 was 14bps, which is considerably lower than normalized provisioning levels owing to healthy asset quality and write-backs.

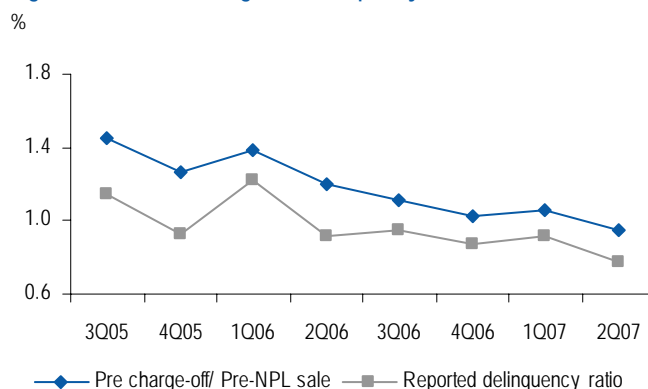
With NPL coverage at 180% as of 2Q07, which indicates that PSB is well provided at this time, and continued benign credit cycle at PSB, we believe that credit costs should remain below the normalized level (JPMorgan estimate: 50-80bp) in the near-term. Delinquencies also remain low with pre charge-off/pre-NPL sale delinquencies for the SME segment still below the 1% level despite a rise in 2Q07 and for retail delinquencies to remain stable.

Figure 6: PSB—SME segment delinquency trend



Source: Company reports and JPMorgan estimates.

Figure 7: PSB—Retail segment delinquency trend



Source: Company reports and JPMorgan estimates.

Key points asset quality

- PSB's corporate loan book being more concentrated in the manufacturing sector (47% of corp. loans in manufacturing) and also being less exposed to the real estate segment (15% exposure to real estate segment), seems to have lower credit risk compared to its peers. As the major industries especially shipbuilding expected to sustain strong growth in the mid-term credit risk seems low.
- Recently, a prominent regional construction company, Shinil had gone bankrupt and hence there have been concerns on the real estate PF loan book. At this time, real estate PF accounts for 60% of total PF loans but the risk is quite low as almost all of the borrowers are grade A developers such as Lotte Construction and Doosan.
- On the retail side, we believe the real estate market is the greatest risk factor. In the case of PSB, due to its comparatively lower exposure to mortgage loans (mortgage loan proportion PSB: around 13% vs. nationwide bank average: around 20%) and collective loans, credit risk related to the real estate market seems relatively lower. In relation to housing prices in Pusan, as prices have been flat for the past few years the risk of a severe drop in housing prices seems minimal and to add, there seems to signs of a slight recovery going forth.

Valuation

FY07E NP increased by 6.7%

We are increasing our NP estimate for FY07 by 6.7% to W271 billion and for FY08 by 8.8% to W298 billion as we believe that core earnings growth should be strong going forth on the back of a stable NIM and high loan growth in 1H07. We reiterate that we believe PSB management should continue to focus on profitability and that the business environment in the Pusan/Kyongnam area should remain favorable.

Key assumptions for FY07

- Average NIM (JPMorgan model based) for FY07 is assumed to be 3.27% from the previous 3.25% based on more favorable NIM trend expected going forth as less pressure may be imparted on both on the funding and asset pricing side.
- Loan growth for FY07 raised to 14% on account of PSB already reaching the 11% mark as of 2Q07.
- Provisioning level (provisions-to-average credit balance) for FY07 assumed to be 31bps, slightly lower than our previous 32bp assumption taking into account higher write-back factors expected.

Table 2: PSB—Change in forecasts

Won in billions, year-end December

	Pre-provision Op			Net Profit			EPS (Won)		
	New	Old	Chg.	New	Old	Chg.	New	Old	Chg.
FY06	331	331	0.0	184	184	0.0	1,253	1,253	0.0
FY07E	430	408	5.6	271	254	6.7	1,849	1,732	6.7
FY08E	479	446	7.4	298	274	8.8	2,032	1,868	8.8

Source: Company reports and JPMorgan estimates.

Target price raised to W20,000

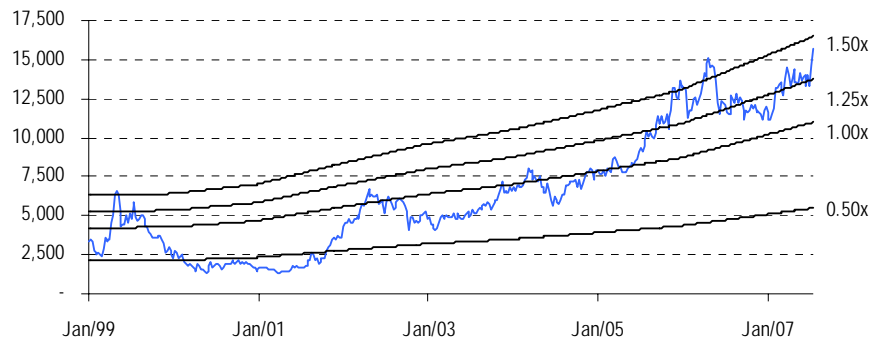
We are raising our target price to W20,000 based on our adjustment of the base period to June 2008 from December 2007 and also a slight increase of PSB's sustainable ROE to 14.36% from our previous 14.24%. Stabilization of NIM and commitment of management towards profitable growth has given us increased confidence towards PSB. The new target price of W20,000 is based on our dividend discount model analysis and implies 1.7x FY08E BVPS and 9.8x FY08E EPS.

Potential risk factors

- Unforeseen regulation changes could negatively affect our view on the company.
- Unforeseen corporate bankruptcies could negatively affect our view and earnings forecast on the company.
- If the domestic economy deteriorates more than our estimates, our forecast for provisions and earnings could be negatively affected.
- Building up of severe competition in the respective markets of PSB.

Figure 8: PSB--12 month forward P/B trend

Won



Source: Company reports and JPMorgan estimates.

Pusan Bank— Rating and price target changes as of July 18, 2007

Company	Ticker	Date	Rating	Target price/Fair value	
				Price (W)	Basis
Pusan Bank	005280 KS	October 22 2003	Overweight	7,745	12-month
		November 14 2003	Overweight	7,745	12-month
		February 05 2004	Overweight	7,745	12-month
		May 03 2004	Overweight	9,200	12-month
		July 27 2004	Overweight	9,200	12-month
		Sep 15, 2004	Overweight	9,200	12-month
		October 27, 2004	Overweight	9,200	12-month
		January 25, 2005	Overweight	9,200	12-month
		February 1, 2005	Overweight	9,200	12-month
		April 26, 2005	Overweight	9,900	12-month
		July 26, 2005	Overweight	12,000	12-month
		August 13, 2005	Overweight	12,000	12-month
		October 27, 2005	Overweight	12,500	12-month
		November 28, 2005	Neutral	12,500	12-month
		January 24, 2006	Neutral	12,500	12-month
		February 2, 2006	Neutral	14,000	12-month
		March 2, 2006	Neutral	14,000	12-month
		April 26, 2006	Neutral	16,000	12-month
		July 21, 2006	Neutral	14,000	June-2007
		Jan-30, 2007	Overweight	14,500	Dec-07
		Mar-18, 07	Overweight	17,000	Dec-07
		Apr-4, 2007	Overweight	17,000	Dec-07
		Apr-10, 2007	Overweight	17,000	Dec-07
Apr-19, 2007	Overweight	17,000	Dec-07		
Apr-22, 2007	Overweight	17,000	Dec-07		
May-9, 2007	Overweight	17,000	Dec-07		
July-1, 2007	Overweight	17,000	Dec-07		

Source: Bloomberg, JPMorgan.

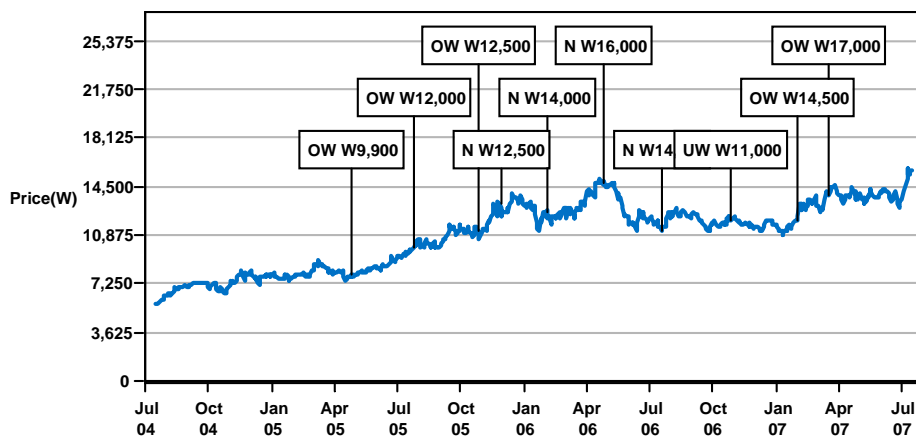
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Pusan Bank (005280.KS) Price Chart



Date	Rating	Share Price (W)	Price Target (W)
27-Apr-05	OW	7860	9900
26-Jul-05	OW	9950	12000
27-Oct-05	OW	11100	12500
28-Nov-05	N	13200	12500
02-Feb-06	N	12600	14000
25-Apr-06	N	14700	16000
19-Jul-06	N	11100	14000
27-Oct-06	UW	11900	11000
31-Jan-07	OW	12000	14500
18-Mar-07	OW	13800	17000

Source: Reuters and JPMorgan; price data adjusted for stock splits and dividends.
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Coverage Universe: **Joon Seok:** Daegu Bank (005270.KS), Jeonbuk Bank (006350.KS), Korea Exchange Bank (004940.KS), Pusan Bank (005280.KS), Solomon Mutual Savings Bank (007800.KS), Woori Financial Group (053000.KS)

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JPM Global Equity Research Coverage	44%	41%	16%
IB clients*	50%	50%	38%
JPM SI Equity Research Coverage	40%	47%	13%
IB clients*	69%	62%	48%

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Pusan Bank: Summary of financials

Won in billions, year-end December

Income statement - WB					Growth Rates				
	2005	2006	2007e	2008e		2005	2006	2007e	2008e
Margins (% of Earning Assets)	3.62%	3.28%	3.28%	3.24%	Gross Loans	10.2%	22.4%	14.0%	11.0%
Earning Assets/Assets	91%	92%	92%	91%	Customer deposits	7.3%	1.7%	8.1%	9.0%
NIM (as % of avg. Assets)	3.28%	3.03%	3.01%	2.94%	Total assets	1.8%	1.6%	1.8%	1.8%
Net Interest Income	593	617	710	791	Shareholders' equity	11.8%	11.5%	16.6%	14.6%
Total Non-Interest Revenues	101	105	137	127	Net Interest Income	1.8%	4.1%	15.1%	11.3%
Fee income	97	106	120	122	Total Non-Interest Revenues	73.9%	4.1%	30.9%	-7.2%
FX/Trading gains	3	(1)	17	6	Total Operating Revenues	8.4%	4.1%	17.3%	8.4%
Other operating income	(0)	0	0	(0)	Operating costs	11.9%	4.5%	6.7%	5.4%
Total Operating Revenues	694	722	847	918	Pre-provisioning Operating Profit	4.5%	3.6%	29.9%	11.3%
Operating costs	(374)	(391)	(417)	(439)	Loan loss provisions	-31.9%	-40.9%	-0.2%	35.9%
Operating profit	320	331	430	479	Attributable Net Income	34.8%	2.7%	47.5%	9.9%
Loan loss provisions	(86)	(51)	(51)	(69)	EPS	34.8%	2.7%	47.5%	9.9%
Other provisions	16	(23)	(5)	1	DPS	35.0%	4.9%	35.3%	13.0%
Exceptionals	0	0	0	0	Balance Sheet Gearing				
Disposals/ Other income	16	(23)	(5)	1	Loan/Deposit	93.3%	112.3%	118.6%	120.8%
Pre-tax Profit	250	257	375	411	Investment/Assets	25.5%	22.7%	20.9%	20.6%
Tax	(71)	(74)	(104)	(113)	Loan/Assets	64.0%	68.8%	66.8%	67.1%
Minorities/preference dividends	0	0	0	0	Customer deposits/Liab.	73.0%	65.1%	59.8%	59.1%
Attributable Net Income	179	184	271	298	LT Debt/Liabilities	20.7%	25.2%	24.7%	25.5%
Per Share Data					Asset Quality/Capital				
	2005	2006	2007e	2008e		2005	2006	2007e	2008e
EPS (Won)	1,220	1,253	1,849	2,032	Loan loss reserves/Loans	1.5%	1.4%	1.3%	1.3%
Payout ratio	33%	34%	31%	32%	NPLs/Loans	0.9%	0.8%	0.6%	0.1%
NAV (Won)	7,816	8,718	10,163	11,647	Growth in NPLs	-19.9%	9.3%	-22.3%	-85.0%
Avg. Shares issued (mn)	147	147	147	147	Tier 1 Ratio	9.1%	9.4%	10.1%	10.9%
					Total CAR	12.2%	12.8%	12.7%	13.4%
Key balance sheet - WB					Du-Pont Analysis				
	2005	2006	2007e	2008e		2005	2006	2007e	2008e
Net Customer Loans	12,186	14,932	17,052	18,931	NIR/Avg. Assets	3.28%	3.03%	3.01%	2.94%
Gross Loans	12,375	15,152	17,273	19,173	Non IR/Total Rev	14.5%	14.5%	16.2%	13.9%
Other Earning Assets	422	299	836	911	Cost/Income	53.9%	54.1%	49.2%	47.8%
Average Earning Assets = (A)	16,389	18,806	21,687	24,441	Cost/Assets	2.07%	1.92%	1.76%	1.63%
Total assets	19,050	21,711	25,544	28,205	Operating ROAA	1.77%	1.63%	1.82%	1.78%
Interbank funding	0	0	0	0	Loan/Assets	65.2%	67.5%	68.6%	67.8%
Customer deposits	13,066	13,293	14,376	15,670	Other inc:provs	0.09%	-0.11%	-0.02%	0.00%
Other Interest Bearing Liabilities	1,131	1,985	3,724	4,064	Tax	28.3%	28.6%	27.7%	27.5%
Average Interest Bearing Liab. = (B)	16,423	18,540	21,202	23,852	MI	0.00%	0.00%	0.00%	0.00%
Average Assets	18,092	20,380	23,627	26,874	ROAA	0.99%	0.90%	1.15%	1.11%
Shareholders' equity	1,147	1,279	1,491	1,708	RoRWA	1.58%	1.48%	1.96%	1.91%
Risk Weighted Assets	11,951	12,855	14,814	16,367	Equity/Assets	6.0%	6.0%	5.9%	6.0%
Average Risk Weighted Assets	11,312	12,403	13,834	15,591	ROE	16.47%	15.15%	19.58%	18.63%

Source: Company data, JPMorgan estimates.